FRBSF Weekly Letter

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Bank Regulation and Deposit Insurance

It is commonly accepted that the present deposit insurance system encourages excessive risk-taking because it gives depositors little incentive to monitor the financial condition of the institutions where they place their funds. Moreover, since bank regulators allow undercapitalized institutions to continue in operation even after they have exhausted their net worth on a market-value basis, the incentive to take excessive risk is greatly enhanced. Closing failing institutions promptly would eliminate much of this distortion in risk-taking, but such a goal is practically unattainable given the difficulties inherent in measuring the market value of insured institutions. As a result, some form of direct control over risk-taking is needed. Last week's *Letter* considered risk-adjusted pricing of deposit insurance and found that, because of limitations in our ability to appraise the market value of insured institutions and the riskiness of their portfolios, it may not be the panacea its proponents claim.

Another approach to the deposit insurance problem is the regulation of bank portfolios. Such an approach has received bad press of late because, its critics argue, the regulators have not kept banks from undertaking excessive risks. A review of recent headlines concerning bank failures and problem loans (particularly to energy-related firms and to lesser-developed countries) would tend to confirm this view. Moreover, from the standpoint of economic efficiency, regulation seems, at first glance, a less desirable approach because it arbitrarily imposes uniformity and thus prevents insured institutions from taking advantage of differences in risk preferences and various economies (e.g., specialization, information, etc.) that would, in the absence of regulation, generate social benefits. Despite these drawbacks, however, a regulatory approach to the problem of excessive risk-taking is worth a second look.

Restrictive covenants...

One of the criticisms lodged against regulation is that it produces less efficient results than "market-oriented" approaches. However, the existence of restrictive covenants in private long-term debt contracts suggests that, even in private market agreements, some form of outright "regulation" of risk-taking may, at times, be more efficient than pricing. In the long-term debt market, one of the greatest risks faced by investors is the possibility that the issuing firm will not be declared bankrupt until it has more than exhausted its equity capital and has therefore jeopardized the value of the bondholders' investments. In theory, the pricing of long-term debt could take this possibility into account. However, the premium required might be so high that no market for long-term debt would exist. Consequently, the firm's shareholders and its long-term creditors find it mutually beneficial to agree to restrict the firm's risk-taking options instead.

These covenants generally place restrictions on the issuing firm's dividend, financing and/or investment policies by specifying, for example, the percentage of retained earnings that can be paid out in dividends or the minimum amount of capitalization the firm must have. Violations of these covenants give the bondholders the right to renegotiate the terms of the indenture or even to declare the firm in default and then to seize collateral or accelerate the maturity of the debt, possibly forcing the firm into bankruptcy.

...and bank regulations

Bank regulation has much in common with these covenants. Regulations regarding, among other things, loan concentrations, insider transactions and capital adequacy standards constrain banks' investment and financing choices and serve to protect the deposit insurance fund from the same kinds of risks faced by bondholders. Regulations limiting (in proportion to a bank's capital) both concentrations of loans to any given borrower and transactions between a bank and its executive officers, directors or principal shareholders are similar to bond covenants that place restrictions on the types of assets a firm can acquire. Likewise, regulations regarding debt issuance and pledged assets constrain banks' abilities to dilute the claims of the insurance fund as do bond covenants restricting a firm's ability to issue new debt with claims senior to those of existing debtholders. Also, like many bond contracts, bank regulators require that banks have an adequate system of internal audits and that they purchase insurance to

protect against certain types of risk such as theft, fraud and employee infidelity.

The most significant check on the actions of a bank's shareholders is the enforcement of capital adequacy standards. A minimum capital standard limits the extent to which a bank can issue more deposits and thereby increase the size of the FDIC's liability without also increasing the aggregate value of the shareholders' exposure. Policies on bank capital also significantly constrain a bank's ability to follow risky lending and investment policies. Typically, banks are required to subtract from their capital base the (book) value of loans that the regulators deem to have a high probability of default. Such an approach forces shareholders to recognize capital losses and thus to absorb more of the costs of risky lending policies. To the extent that such capital policies are stringently enforced, the price of bank stock should reflect this, providing some private market discipline of bank risk-taking.

Given all the similarities between restrictive bond covenants and bank regulations, it appears that, in theory at least, the regulatory approach can address the problem of bank risk-taking effectively. However, this begs the question whether the *current* regulatory limits on banks' activities are stringent enough to be effective. For example, the FDIC has recently set a minimum capital-to-total-assets ratio of 5½ percent for the banks it insures. The FDIC has also stated that higher capital standards will be set for banks that are considered riskier. (Capital includes reported equity capital, reserves—including loan loss reserves—and mandatory convertible subordinated debt, net of loans the FDIC has classified as having a high probability of default.) Given the large losses incurred by the FDIC over the last few years ($2.2 billion between 1980 and 1983), however, it is fair to say that this standard is probably not stringent enough. Reliance on reported (i.e., book value) equity capital further weakens the effectiveness of this regulation since the existence of unrealized losses or highly uncertain earnings prospects frequently cause the market value of bank equities to fall below their book values.

Enforcement

The establishment of sufficiently stringent regulatory standards is only half the battle, of course. Those standards must then be enforced. The regulators must have the authority and the willingness to take appropriate action when an institution violates a regulation. Whether bank regulators have adequate authority to enforce their regulations is a subject of some debate, at least among the regulators. For example, the FDIC has sought legislation to give the agency full enforcement powers over the banks it does not supervise directly. (Currently, the FDIC supervises only the state-chartered nonmember banks, while the Comptroller of the Currency and the Federal Reserve System supervise, respectively, the nationally chartered banks and the state-chartered member banks.)

As a group, however, bank regulators have substantial powers to enforce regulations. These powers include the authority to enter into formal and informal agreements with offending banks, thwart offending banks' expansion plans, issue cease-and-desist orders, impose civil money penalties, suspend/remove bank officers and directors and, in the case of the FDIC, terminate deposit insurance coverage. Compared with the enforcement powers granted bondholders (e.g., authority to renegotiate the terms of the indenture, seize collateral and accelerate the maturity of the debt), the bank regulators' powers stack up quite well.

As a first step in inducing a bank to change its behavior, the regulators attempt to obtain some agreement from the bank to rectify the problem (including a plan to increase capital, if appropriate). Examinations are then scheduled at more frequent intervals to monitor the bank's efforts to change its practices. Should agreements and more frequent examinations prove ineffective, the regulators may decide to deny a bank's applications to expand. This approach has been used, for example, as a means of forcing a bank to improve a seriously impaired capital structure. The bank regulators have been criticized, however, for not making greater use of this authority. For example, bank regulators could have used this authority

more extensively as a means of preventing bank capital ratios from dropping during the 1970s and early 1980s. The decline was especially pronounced at the large banks, where capital fell below five percent of assets between 1978 and 1981.

The regulators also have the ability to threaten and initiate legal proceedings against a bank. However, because of the costs and delays involved in imposing these sanctions, the regulators generally do not resort to them except in the most extreme cases. Cease-and-desist authority, for example, has been used only in cases of *serious* multiple infractions, such as insider abuses, unsafe lending practices and serious impairment of capital. Likewise, civil money penalties are not generally imposed until a bank has violated a cease-and-desist order, even though the regulators have the authority to impose penalties under other circumstances. Moreover, the authority to suspend or remove bank officers and directors is seldom used.

Finally, the FDIC has shown considerable reluctance to terminate deposit insurance coverage to reduce its risk exposure. This reluctance is particularly unfortunate since termination of deposit insurance is tantamount to a declaration of insolvency and as such, would help to overcome the FDIC's lack of authority to close insolvent institutions. Between 1966 (when regulators were granted cease-and-desist powers) and 1983, the FDIC initiated an average of only six termination proceedings a year—far below the annual average of 284 banks that were considered problem institutions over that same period.

Thus, although the regulators have considerable authority to take actions against a bank that represents a substantial risk to the deposit insurance fund, such authority is used infrequently. Ultimately, this reluctance increases the losses borne by the FDIC and encourages greater risk-taking.

The solution?

The regulatory approach to the problem of bank risk-taking has been criticized as ineffective and economically inefficient. However, the use of regulation-like restrictive covenants in bond contracts suggests that such an approach is neither inherently ineffective nor inefficient. Whether the regulators would design the same regulatory standards as the private market is, of course, open to debate. Nonetheless, a comparison of bank regulations and restrictive bond covenants reveals certain similarities, suggesting that the problem with current bank regulation is simply that it is not stringent enough. Indeed, the need for reform of the deposit insurance system would seem less pressing today if the regulators had made better use of their existing authority to control risk-taking.

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 8/1/84	Change from 7/25/84	Change from 12/28/83 Dollar	Change from 12/28/83 Percent Annualized
Loans, Leases and Investments[1] [2]	181,867	324	5,842	5.5
Loans and Leases[1] [6]	162,873	433	7,518	8.1
Commercial and Industrial	48,945	− 78	2,982	10.8
Real estate	60,583	91	1,684	4.7
Loans to Individuals	28,992	120	2,341	14.7
Leases	5,005	0	− 58	− 1.9
U.S. Treasury and Agency Securities[2]	11,835	− 109	− 672	− 9.0
Other Securities[2]	7,159	− 1	− 1,004	− 20.6
Total Deposits	190,380	4,214	− 617	− 0.5
Demand Deposits	45,847	3,687	− 3,390	− 11.5
Demand Deposits Adjusted[3]	29,756	1,130	− 1,575	− 8.4
Other Transaction Balances[4]	12,475	402	− 300	− 3.9
Total Non-Transaction Balances[6]	132,058	124	3,073	3.9
Money Market Deposit Accounts—Total	37,946	− 43	− 1,651	− 6.9
Time Deposits in Amounts of $100,000 or more	40,585	86	2,420	10.6
Other Liabilities for Borrowed Money[5]	21,425	1,911	− 1,582	− 11.5

Weekly Averages of Daily Figures	Period ended 7/30/84	Period ended 7/16/84
Reserve Position, All Reporting Banks		
Excess Reserves (+)/Deficiency (−)	61	− 23
Borrowings	111	59
Net free reserves (+)/Net borrowed(−)	− 50	− 81

1 Includes loss reserves, unearned income, excludes interbank loans
2 Excludes trading account securities
3 Excludes U.S. government and depository institution deposits and cash items
4 ATS, NOW, Super NOW and savings accounts with telephone transfers
5 Includes borrowing via FRB, TT&L notes, Fed Funds, RPs and other sources
6 Includes items not shown separately